COMMENTARY: INVESTORS, IPOS, AND THE INTERNET

DONALD C. LANGEVOORT*

The Internet seems a natural home for the conduct of public offerings, including IPOs. By now, nearly all investors with the inclination and resources to purchase in a public offering have the technological resources to do so electronically. Email and websites offer a low-cost way to communicate information quickly and gauge interest easily with respect to large numbers of potential buyers. The SEC's 2005 Public Offering Reforms,[1] though no doubt more cumbersome than they should be, have a carefully thought out approach to electronic communications. Indeed, their most important innovation—permitting the use of "free writing prospectuses" (i.e., sales literature) prior to the effective date of the registration statement—treats electronic communication as the preferred means by treating an active hyperlink as the equivalent of delivery of the preliminary prospectus.[2] Other forms of written communication require actual physical delivery in the IPO setting, which is more costly and burdensome.

There are more dramatic possibilities, as described and analyzed in the papers in this symposium. Most notably, the Internet makes it possible to change the very nature of the public offering process, shifting away from the book-building system—which is very expensive for the issuer—to an auction-style model in which investors will simply bid electronically for shares, with the price set at the level that clears the market. The papers in this symposium give many different perspectives on this potential, urging caution before professing too much faith in the promise of the Internet as the gateway for fundamental IPO reform. In their writings both here and elsewhere, Peter Oh[3] and Christine Hurt[4] have analyzed many of the

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* Thomas Aquinas Reynolds Professor of Law, Georgetown University Law School.

[1] Securities Offering Reform, Exchange Act Rel. No. 8591, 2005 WL 1692642 (July 19, 2005). For a critical analysis suggesting that these reforms may have gone too far, see Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 CATH. U. L. REV. 561 (2007).

[2] Rule 433(b)(2)(i) note 1; see JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 185-87 (5th ed. 2006); Broc Romanek & Julie Hoffman, *A New Day Dawning for E-communications During the Offering Process*, 37 U. TOL. L. REV. 365 (2006).

[3] Peter Oh, *A View of the Dutch IPO Cathedral*, this volume; Peter Oh, *The Dutch Auction Myth*, 42 WAKE FOREST L. REV. 853 (forthcoming 2007).

[4] Christine Hurt, *Initial Public Offerings and the Failed Promise of Disintermediation*, this volume; Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711 (2005).

institutional and economic challenges that Internet-based auctions face in order to become fully competitive with the book-building process.

The basic point, with which I fully agree, is that the IPO is only partly about efficient communication. Hurt emphasizes that one of the crucial roles of the underwriting syndicate is to *create* demand[5]. The old adage is that stocks are sold, not bought—in other words, that it takes marketing and sales work to get people to want to buy securities in a company with no track record and hence little or no pre-existing credibility in the financial markets. In addition to bringing marketing expertise to the task, the underwriters act as reputational intermediaries, using their credibility to vouch for the issuer.[6] This is naturally expensive and risky, and it is hard to imagine low-cost solutions to the problem of informational asymmetry in capital-raising transactions because of this. To be sure, as Victor Fleischer writes,[7] sometimes brand names can substitute at least partially in credibility-bonding (Google, for example), but this will be rare and, even then, probably only partial.

I suspect, then, that sales and marketing efforts by securities professionals will continue to dominate the public offering process, whether through electronic or more old-fashioned forms of communication. While book-building efforts will no doubt change in response to new technology, specialist intermediaries will best be able to exploit these opportunities, meaning that the securities industry will continue to play a dominant role in public offerings. The potential problems—the anti-competitive behavior, under-pricing, self-dealing and manipulation that Jim Fanto[8] writes about here, for example—will be with us for some time to come.[9]

If so, then regulating the IPO will continue to involve casting a wary eye on, among other things, underwriter and broker sales efforts. For instance, we encounter an interesting regulatory point, because the argument is sometimes heard that technology empowers investors (through greater access to information) in such a way that they are now better able to protect themselves. That might suggest that regulatory oversight is less important. My secondary point in this commentary is that there is an interesting and fast-growing body of empirical research on investor

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[5] Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711 (2005).

[6] *See* Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

[7] Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581 (2006).

[8] James Fanto, *The Continuing Need for Broker-Dealer Professionalism in IPO's*, this volume.

[9] *See also* Dale A. Oesterle, *The High Cost of IPOs Depresses Venture Capital in the United States*, 1 ENTREPREN. BUS. L.J. 369 (2006). This is not to say that all of this is necessarily opportunistic, as Richard Booth points out in his article. *See* Richard Booth, *Going Public, Selling Stock, and Buying Liquidity*, this volume.

behavior,[10] much of which now deals with Internet-based investing. Understanding how investors make their choices is key to setting the right policy, and so regulators should pay very close attention to this work.[11] Here, I want to offer just a few examples.

The most illuminating data comes from a broad database made available by Charles Schwab, the historic leader in on-line investing. Brad Barber and Terry Odean have dug deeply to look at the trading behavior of on-line investors and found that the combination of informational richness and speed of execution can produce interesting feedback effects.[12] Positive feedback—buying followed by price increases—generates a false sense of confidence, ignoring the substantial likelihood that this was the product of simple luck. The result is increasingly more active trading that mimics the market in terms of the returns that are generated (i.e., no evidence of abnormally high or low returns), but the investors are systematically net losers because the increasing velocity of trading imposes large commission fees. In an overview of Internet-based investing, Barber and Odean warn that the trading environment there can create a false sense of investor empowerment, and hence overconfidence.[13] That is something just waiting to be exploited by savvy salespeople.

The common response to these concerns is that investors will learn from their experience. But research regarding investor behavior gives reason to doubt how effectively investors really learn. Negative feedback is useless if either delayed too long or ambiguous, and both conditions describe much of the feedback in the securities markets. My favorite illustration of this is an experimental game devised by Don Moore and his colleagues at Carnegie-Mellon, who had MBA students play a simulated mutual fund investment game using computer-based trading.[14] Questions posed during interruptions in the game found support for the main

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[10] I survey this literature without paying particular attention to the Internet in Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996). Presumably, the psychology of investor decision-making does not change simply because the Internet is used; rather, web-based investing simply changes the nature of the purchaser-seller interaction.

[11] For other legal work on this subject, see Lynn A. Stout, *Technology, Transactions Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?*, 75 WASH. U. L.Q. 791 (1997); Tamar Frankel, *The Internet, Securities Regulation, and Theory of Law*, 73 CHI.-KENT L. REV. 1319 (1998).

[12] *See* Brad M. Barber & Terrence Odean, *Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 55 J. FIN. 773 (2000); *see also* Brad M. Barber & Terrence Odean, *Online Investors: Do the Slow Die First?*, 15 REV. FIN. STUD. 455 (2002).

[13] *See* Brad M. Barber & Terrence Odean, *The Internet and the Investor*, 15 J. ECON. PERSPECTIVES 41 (2001).

[14] *See* Don Moore et al., *Positive Illusions and Forecasting Errors in Mutual Fund Investment Decisions*, 79 ORG. BEHAV. & HUM. DECISION PROCESSES 95 (1999).

hypothesis—that the players overestimated their chances of doing better than average by game's end.[15] But that was not terribly surprising. The more interesting finding came when they asked each player how well they had already done thus far in the game. The players' estimates were significantly greater than the reality, even though reality was easily accessible through one or two clicks on the screen. People are motivated to see themselves as doing well at competitive tasks, and may be selective in perception when filling out their own report cards. That is another investor tendency that can readily be exploited.

Another area where research into investor behavior has produced intriguing results is in mutual fund investing. One reason this research is so important is that there are distinct "channels" for the distribution of mutual funds—direct and broker-sold.[16] There is ample evidence that investors pay a high price for broker involvement; the costs increase without any significant evidence of better returns. With respect to mutual fund investments generally (including direct investing, much of which is done via the Internet), we still observe that investors over-value some available information and under-value other information. Most significantly, investors chase trends and extrapolate excessively based on past performance.[17] Though they show high sensitivity to front-end load fees, they are far less sensitive to less salient expenses such as 12b-1 fees and redemption fees.[18] Overall, effective advertising pays off well beyond any possible useful informational content of the ads.[19]

The bottom line of all this is that making information available to investors does not mean that they will use it at all, much less use it well. That is the concern, because as noted earlier it would be nice to think (and securities industry advocates certainly claim) that Internet-based information availability can be a good substitute for sales conduct regulation. Information lets investors protect themselves. That will sometimes be so, but the game still favors the skilled salespeople.

This is not an argument against either liberalization of public offering processes or encouragement of Internet-based offerings, but just a note of caution. The trend, to be sure, is against prior restraint in sales practices and in favor of investor choice. My point is simply that regulators and policy-makers keep a careful eye on Internet-based sales practices to

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[15] *Id*, at 10,11,16.

[16] *See* Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. ECON. PERSPECTIVES 161, 168-69 (2004).

[17] *See e.g.*, Erik Sirri & Peter Tufano, *Costly Search and Mutual Fund Flows*, 53 J. FIN. 1589 (1998).

[18] *See* Brad M. Barber et al., *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. BUS. 2095 (2005).

[19] *See* Prem C. Jain & Joanna Shuang Wu, *Truth in Mutual Fund Advertising: Evidence on Future Performance and Fund Flows*, 55 J. FIN. 937 (2000).

see where unfair exploitation might occur,[20] and respond accordingly. For this to be effective, however, there is a need for much more empirical work about investor behavior, online and otherwise, than we presently have. And this is a task that the SEC should attend to as well in the future.

[20] For a first step by the SEC—but one that has not since been updated—see SEC Special Study, *On-Line Brokerage—Keeping Apace of Cyberspace*, [1999-2000 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,222 (Nov. 22, 1999).